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ON THE VIABILITY OF AGRICULTURAL DEVELOPMENT BANKS: CONCEPTUAL FRAMEWORK

by

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Abstract

The main problem of public agricultural development banks is their lack of viability, mostly reflected by the decline in the real value of their loanable funds, as a consequence of inflation, poor loan collection, and operational losses. As a result, these banks have lost support from their clientele, international donors, and governments. The conceptual framework for traditional agricultural credit programs is contrasted with the new Ohio State University view on rural financial markets. Viability requires reaching larger numbers of customers with a wider range of financial services, including deposit facilities; increasing the volume of purchasing power transferred from surplus to deficit units through market-oriented intermediation; improving the quality of the services provided and guaranteeing permanent access to the services of these institutions; and lowering transaction costs for all market participants. Viability requires environment and policy changes, institutional strengthening, and technological innovation.

ON THE VIABILITY OF AGRICULTURAL DEVELOPMENT BANKS: CONCEPTUAL FRAMEWORK[1]

by

Claudio Gonzalez-Vega[2]

I. Introduction

During the past decade, the preoccupation among bankers, representatives of international agencies, and the financial authorities of the developing countries, as well as among professionals concerned with economic development, regarding the performance of the agricultural development banks, has been increasing.[3]

These banks were created several decades ago, with the objective of supplying, either the longer-term credit that the commercial banks were not prepared to grant, or the loans demanded by specific clientele, such as medium and small farmers, who lacked adequate

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[1] This paper was prepared for the Office of External Review and Evaluation (ORE) of the Inter-American Development Bank (IDB), as background material for the Study of the IDB's Experience with Institutional Strengthening Assistance, under the direction of Francisco Guzmán. The author is solely responsible for the views expressed here. These views may or may not be shared by the sponsoring institution.

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[3] An earlier concern with the performance of the public agricultural development banks was strongly voiced by the Rural Financial Markets Program at the Ohio State University. These preoccupations were summarized by Compton Bourne and Douglas H. Graham in "Problems with Specialized Agricultural Lenders," in Dale W Adams, Douglas H. Graham, and J. D. Von Pischke, eds. Undermining Rural Development with Cheap Credit, Boulder, Colorado: Westview Press, 1984.

access to the financial services of the traditional banking sector, but who were considered to be a priority by the governments of the developing nations. These target clientele have been among the riskiest and costliest to supply with financial services.

Publicly-owned, most of the time, the agricultural development banks have received the largest share of their funds from international agencies, governments, or central banks, and have granted credit, to the extent allowed by the availability of these public-sector-determined funds, to beneficiaries who have not always possessed the requirements of creditworthiness, frequently at subsidized interest rates.

As claimed in the 1989 World Development Report, "in practice, the development finance institutions found it difficult to finance projects with high economic but low financial rates of return and remain financially viable at the same time ... Today many of them are insolvent. If they are to remain in operation, they will have to be restructured."[4] The need for institutional transformation, in order to achieve their viability, is particularly urgent in the case of the public agricultural development banks.

II Lack of Viability

The main problem of the public agricultural development banks has been their lack of viability. A viable financial institution is self-sustaining and valued by its clientele. This requires an agency that is able to cover its costs, that provides high quality services, that reaches an increasing number of customers, that is dynamic in providing new financial

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[4] World Bank, World Development Report 1989, New York: Oxford University Press, 1989, p. 106.

services and products, and that actively searches for ways of improving its efficiency, as reflected by the level and the degree of dispersion of the transaction costs incurred by its depositors, its borrowers, and the intermediary itself. Viable institutions possess credibility and are able to mobilize deposits from the public, to collect their loans, and to retain good management and staff.[5]

Their lack of viability has been reflected by a steady reduction of the relative importance of the public agricultural development banks within the financial sector of the developing countries. This, in turn, has threatened the survival of these banks, since the less important an institution is, the easier it becomes to scrap it. This decline in their relative importance has occured because most agricultural development banks have not been able to increase and, in many instances, even to sustain the flow of their loanable funds, in real terms. On the contrary, their lending capacity has sharply decreased.

The lending capacity of the agricultural development banks has declined, in turn, because they have not protected their portfolios from inflation, because they have not vigorously collected their loans, in order to be able to grant new credit, because they have not aggressively mobilized local resources, in order to be able to widen the range of their services, and because, in view of the poor quality of their services and the high transaction costs that they impose, they have lost the support of their clientele. Moreover, as their institutional weaknesses have become increasingly evident, they have lost the support of the international agencies, as well, and, as a result, their loanable funds have substantially

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[5] See Richard L. Meyer, "The Viability of Rural Financial Institutions and the System as a Whole," Report of the Fourth Technical Consultation on the Scheme of Agricultural Credit Development, Rome: FAO, 1988, pp. 41-44.

declined. Ironically, their lack of viability has been, in large part, a consequence of their strong dependency on outside funds, from international donors, central banks, and governments.

Given their strong financial dependency and the absence of a mobilization of deposits from the public, there has been a growing political intrusion in the agricultural development banks, in the sense that the decisions about who to lend to, what to lend for, and in what terms and conditions to lend have not been autonomously taken by the financial intermediary, but have been imposed from the outside by the external sources of funds. The criteria used by these other agencies have not necessarily been compatible with the institution's viability.

Lacking viability, the survival of the public agricultural development banks has been questioned by many, including their own clientele. Increasing levels of loan default have evidenced this loss of the support of their customers. Loan delinquency has been a signal that the borrowers have not been interested in the survival of the institution. Since they have not expected the institution to be able to provide a permanent service, the value of their relationship with the bank has been low, and they have not taken care to protect it with the timely service of their loan obligations.

Where the public agricultural development banks have not mobilized voluntary deposits from the local community, they have lost the potential support from a mass of depositors. When these have been available, the quality of the services provided to their depositors has determined the extent of their support and, therefore, the bank's ability to grow on the basis of locally mobilized resources. A greater reliance on deposit mobilization has been critical at a time when severe fiscal constraints have reduced the ability of governments to capitalize these institutions with budgetary transfers, when the targets of macroeconomic stabilization programs have eliminated their access to central bank rediscounting, and when the international debt crisis has reduced these banks' access to foreign savings.

The public agricultural development banks have also lost much of the support of the international organizations. These agencies have been increasingly subject to the evaluation of taxpayers and the scrutiny of politicians, most prominently from the United States Congress. The success of the activities promoted by these agencies has been a major criterion in the evaluation of their effectiveness, given an increasing competition among potential users of available funds. The poor performance of the public agricultural development banks has thus jeopardized the reputation of the international agencies that work with them and has led to the withdrawal of their support.

The public agricultural development banks have retained, however, the support of some local politicians, who still see them as mechanisms to favor some groups of society at the expense of others; that is, as instruments for political patronage. The lack of viability of the public agricultural development banks has mostly reflected, precisely, these high levels of political intrusion and the biasing of their objectives away from efficient financial intermediation and towards other political goals.

III. Traditional Conceptual Framework

In order to better understand the deficiencies of the public agricultural development banks, it is useful to consider the conceptual framework that originated the traditional agricultural credit programs. In the first place, the design of the agricultural development banks did not seek as its objective the financial viability of these institutions. The present difficulties should not be surprising, therefore.

In particular, the management autonomy of these institutions was seen as less important than other non-financial objectives to be pursued. These banks were expected to promote the growth of agricultural production, regional development, the adoption of new technology and/or agrarian reform. No one was much concerned about their institutional viability: the available funds were apparently abundant. If these resources were lost, they could be easily replenished. This was the model of the development bank as a top-bottom conduit for outside funds; it was expected to be "succesful" as long as the external resources lasted.

The sound growth and the strength of the financial institution per se were not a priority. What was designed was an instrument to promote other development objectives, even if these purposes created excessive costs and risks for the institution. Burdened by their efforts to reach multiple and frequently inconsistent goals, these banks have been subjected to outside pressures that have weakened their institutional viability.

In order to survive, the agricultural development banks must now emphasize their role as financial intermediaries. They must operate under the assumption that the efficient provision of financial services per se is already an important contribution to economic development. Instead of attempting to promote the production of particular crops or the adoption of specific technological practices, they must recognize that the role of financial intermediation is precisely to improve efficiency via the reallocation of resources through the discipline of the market mechanism. For this reason, what matters most is to strengthen the process of financial intermediation itself.

Second, the design of the traditional agricultural credit programs was characterized by borrower domination. All practices and operational procedures were designed with the interest of the borrowers in mind; not for the sake of depositors or of the institutions. Thus, the rapid disbursement of the funds was favored. Target clientele were chosen independently of their repayment capacity or without any guarantee of recuperation of the funds. Credit was subsidized.

In a depositor-dominated institution, on the other hand, the practices and procedures utilized seek to protect the depositors' savings. In this case, the borrowers' repayment capacity is taken more seriously. In this case, the procedures for and efforts towards loan collection are emphasized more than the quick disbursement of the funds. In this case, portfolio diversification is used as a tool to manage risk, instead of concentrating the portfolio in a few crops or activity types.

Borrower-dominated institutions have been characterized by the absence of a clear concept of risk in their operations. They have attempted, instead, to channel funds to target clientele, for specific purposes, rather than evaluating the borrower's repayment capacity and the degree of risk taken in each case. Within a depositor-dominated intermediary, on the other hand, a careful management of risk is the most important component of the organization's culture.

Third, traditional credit programs have mistrusted the market and have minimized the role of interest rates as a major tool for resource allocation. These programs have preferred, instead, the administrative determination of who to lend to and what to lend for. Because of their dependency on external funds, these decisions have been, in turn, frequently imposed from outside. Price (interest rate) controls have been particularly ineffective, however, in financial markets. Savers have avoided bank deposits when the rates of interest paid have been repressed and as a result the market share of formal financial institutions has declined. Informal, non-regulated, parallel markets have flourished instead.

Supervised credit programs have not trusted farmers, either. Instead, they have insisted on rigidly targeting credit and on a detailed supervision of the use of the funds. These efforts, despite their good intentions, have resulted in unexpected negative consequences. On the one hand, the fungibility of the funds has frustrated attempts to control their end uses. Loans have transfered generalized purchasing power which, combined with the borrower's own resources, has made it possible to finance multiple activities and, thereby, impossible to control the marginal use of the loan funds. Rationing, on the other hand, needed in view of the excess demand created by underpriced credit, as well as an excessive supervision, have both increased transaction costs, for the bank and for the borrowers. These implicit costs have been especially high in the case of small loans. Rigid credit programing, although usually fruitless, has thus been expensive for all market participants and specially for marginal customers.

Fourth, agricultural development banks have been pessimistic about the opportunities for a successful mobilization of local deposits. They have assumed, instead, that rural economic agents do not save, that they do not want to transform some of their assets into bank deposits, and that they do not react to changes in interest rates and in other economic incentives. Those few institutions that have emphasized savings mobilization have been more successful than those agencies that have ignored this dimension of financial intermediation. The former have actually discovered that there is a high demand for deposit facilities in the rural areas of the developing countries and have successfully tapped these additional loanable funds.

In the absence of deposit mobilization, agricultural development banks have been truncated, incomplete, and vulnerable institutions. They have been merely a conduit for the easy disbursement of the funds from external agencies. These funds have gone through the bank, from top to bottom, but have not strengthened it. When disbursement has been quick, it has been a reason for celebration. Loan recuperation, on the other hand, has been less appealing. The borrower knows this and has not been very concerned with timely repayment. The institutional connection with the client has thus been weak and his loyalty has been limited.

Delinquency has been the main signal that the borrowers have not been interested in the institution's survival. Instead, they have taken the loans while the funds have been available, particularly when credit has been subsidized, but have not been concerned about the institution's future. They will not bet on the institution's survival. In due time, default has weakened the institution and has confirmed the client's pessimistic self-fulfilling prediction. The bank has then been caught in a vicious circle.

Timely repayment of the loans is, on the other hand, a recognition of the value for the client of his relationship with the financial intermediary. The most powerful incentive for the borrower's repayment is the expectation of a reliable and continued access to valuable financial services. Few public agricultural development banks have been able to provide this.

The depositor is thus the financial institution's best ally. His concern for the safety of his deposit also contributes to the protection of the intermediary's interests. The key is, however, to make deposit mobilization voluntary. The client must view deposit facilities as a valuable service and not as an imposition or as a mere tool to increase the effective cost of the loans. If savings are forced, instead of being grateful for the service, the client resents the imposition and withdraws the accumulated funds as soon as he can (directly or through a loan) and loses interest in his savings account, which then shows no activity. What matters, therefore, is the quality of service to the client. Quality promotes client support, the healthiest way for an intermediary to grow.

IV. The New View on Finance and Development

The point of departure of a modern analysis of the role of the public agricultural development banks is the recognition that the performance of financial markets matters. The efficient provision of financial services:

(a) increases the productivity of available resources; that is, improves efficiency in resource allocation;

(b) increases the flow of savings and investment, thus contributing to faster economic growth;

(c) favors stability, through greater market integration and opportunities for risk management; and

(d) can improve income distribution, by making available to those with few resources of their own, purchasing power with which to take advantage of their productive opportunities, which otherwise would have to be forgone.

All of this does not happen automatically. There are successful financial systems and there are poorly performing financial systems. There are viable financial intermediaries and there are insolvent financial institutions. In recent times, several developments have threatened efficient financial intermediation.

Most alarming has been inflation, a result in most countries of too rapid a nominal expansion of domestic credit and, as a consequence, of money supply compared to the demand for the money. The accelerating growth of domestic credit has mostly reflected, in turn, the financing of public-sector budget deficits. Frequently, the excessive growth of domestic credit has also reflected substantial quasi-fiscal transfers to the private sector and a multiplicity of subsidies, including underpriced credit. By directly levying a tax on the public's holdings of the liabilities of the financial system, inflation has been this sector's worst foe. When it has accelerated, it has quickly destroyed the financial system of many developing countries. Both inflation and the demand for the foreign exchange needed to service the country's external debt have, in turn, exerted upward pressure on the exchange rate[5]. The resulting devaluation expectations have jeopardized the performance of the domestic financial system as well. While all formal financial institutions have been hurt by these developments, the agricultural development banks have been particularly slow in adjusting to the new environment.

A new approach for the analysis and promotion of rural financial markets has been developed, mostly by researchers at The Ohio State University.[6] A global view, that seeks to understand the performance of the whole financial system, has replaced the partial views of the past. The new approach has adopted a general-equilibrium perspective, a systems approach, and it has abandoned the partial vision and incomplete actions of earlier decades.

Interest has moved away from the design and implementation of specific credit projects and programs, specialized and isolated, towards a concern with the efficiency and integration of financial markets. The new approach has recognized that the purpose of financial policy must be the creation of markets, when these are absent or are incomplete; the improvement of market performance, when this is not efficient; and the use of the power of financial services to integrate other non-financial markets. Following Shaw, the new view has claimed that the contributions of finance to development result precisely from its capacity to integrate markets across the economy.[7]

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[6] See Claudio Gonzalez-Vega, "The Ohio State University's Approach to Rural Financial Markets: A Concepts Paper," Columbus: Rural Financial Markets Program, Ohio State University, 1986.

[7] Edward S. Shaw, Financial Deepening in Economic Development, New York: Oxford University Press, 1974.

The needs for credit and the supply of loans had been traditionally emphasized. This had reflected the domination of financial institutions by the interest of the borrowers. The new view has emphasized, instead, the importance of efficiently supplying the whole range of financial services. It has highlighted, in particular, the existence of a strong demand for better deposit facilities. This emphasis has recognized that all economic agents face costly liquidity management requirements. Moreover, it has considered local deposit mobilization as a powerful tool to increase the viability of financial institutions, a dimension ignored by many public agricultural development banks.

All the emphasis had been placed in the past on interest rates: they must be low, claimed some; they must be high, answered others. The new view has insisted that transaction costs are important, as well, and must not be ignored. Moreover, while interest rates can be set by decree, transaction costs can only be reduced through competition, innovation, and efficiency.

The traditional view had emphasized the search for an ideal type of financial institution. This led to the creation of specialized institutions that enjoyed little success. The new view has predicted that different institutional types possess comparative advantages to reach different clientele and to provide diverse classes of financial services. What matters, therefore, is the performance of the whole system, where numerous and diverse market participants are linked through flows of funds and of information. Thus, economic agents who borrow in one market segment, lend in another and thereby reduce overall transaction costs.

What matters is market integration and the identification of an optimum division of labor among various institutional types, banks and credit unions, public institutions and private agents. For this, the policies that guide their behavior are more important than differences in institutional type. Incorrect policies send wrong signals to all kinds of intermediaries, independently of their organizational structure. This is why a regulatory environment that promotes, rather than represses, competition is critical. Institutional incentives and behavior matter, as well, and a correct organizational structure will in part determine if there is a role for public agricultural development banks within this optimum division of labor among financial institutions.

The traditional view had promoted supervised credit: loans targeted towards specific sectors by reserve requirements and rediscounting programs; channelled to target clientele by the requirements of international agencies; and directed towards special input uses by loan supervision. What matters, however, is the creation of creditworthiness; the existence of economic agents able to borrow, to pay market interest rates, to efficiently use funds, and pay loans back. Timely, untied, flexible loans would allow these creditworthy agents to improve their global financial management and would increase their productivity.

What matter, therefore, are financial intermediaries capable of identifying creditworthy agents at a low cost and of servicing their varied demands for financial services as well as of timely collecting those loans. Supervised credit is a costly and fruitless way to create creditworthiness. The fungibility of credit makes it impossible to control the marginal use of the funds. Given this fungibility, borrowers can easily substitute the money from the loan for their own funds (marginal substitution) or channel them to non-authorized uses (diversion). Additionality is thus limited. Efforts to target credit, on the other hand, have been a major source of transaction costs for the lender as well as for the borrower. Targeting has not only been fruitless; it has been costly as well.

In summary, what is needed are viable institutions, capable of offering a wide range of financial services, to an ample clientele, independently of the end use of the funds. If the interest rates charged are not subsidized, the borrowers will devote the funds to priority uses. They know better than anyone else how to efficiently use those funds. If the loans are expensive, they will economize them.

V. Financial Efficiency and Development Bank Viability

The viability of the agricultural development banks requires self-sufficiency. The bank must be able to operate mostly on the basis of its "own" funds (mobilized deposits) and to make independent lending decisions. Several performance dimensions characterize a viable financial intermediary.

First, the viability of an agricultural development bank will increase to the extent to which it provides access to a wide range of financial services for wide segments of the population. This contribution rests on the provision of a growing range of services, including both loans for different purposes as well as deposit facilities, mechanisms for the transfer of funds, and currency exchanges, as well as other specialized services, once market size has grown sufficiently.

In particular, it has been shown that there is a high demand for deposit facilities in the rural areas of the developing countries, given requirements for liquidity management and reserve accumulation. While not all producers need credit, all of the time, practically all economic units demand liquidity management facilities, such as deposit opportunities, all of the time. Moreover, a depositor does not need to demonstrate creditworthiness in order to open a savings account, while he is who decides when and for how much to deposit or withdraw. The customer is in control of the situation. The bank, in turn, will take into account the client's performance as a depositor when the loan application eventually arrives. Deposits represent, therefore, the easiest way to initiate a banking relationship.

Access to financial services is costly and difficult to supply, however. On the occasion of studies undertaken in over 100 countries for AID's Spring Review of Small Farmer Credit, it was estimated in 1974 that only 15 percent of the agricultural producers of Latin America had access to institutional sources of credit.[8] There might have been some progress since then, but not much. The mere creation of the public agricultural development banks has not been sufficient to significantly increase access.

Second, the viability of an agricultural development bank is strengthened to the extent to which it transfers growing volumes of purchasing power, from depositors with limited investment opportunities, to borrowers with better productive options. The contribution of financial intermediation to economic development precisely consists of the transfer of resources, from less productive uses, to activities where they can be more profitably employed. In this way, deposits substitute for less attractive uses of the funds, while loans make better uses possible. The productivity of resources is thereby improved.

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[8] See Gordon Donald, Credit for Small Farmers in Developing Countries, Boulder, Colorado: Westview Press, 1976.

The extent to which intermediation increases efficiency and, therefore, the viability of the agricultural development bank both depend on the amounts of purchasing power so transferred. What matters is the real value of the channelled funds; their command over resources. What matters is not how many million pesos of credit are granted, but how much seed, fertilizer, or heads of livestock can be purchased with the loan.

The creation and conservation of purchasing power has both macroeconomic requirements and intermediary-level implications. At the macroeconomic level, to create pesos is easy; they can be issued (printed) at the central bank. To create nominal credit is easy, as well. To create purchasing power, on the contrary, is very difficult. This requires that economic agents be capable and willing to save. In addition, they must be willing to place their savings in a financial institution. Thus, the purchasing power channelled through the financial system will increase only if income grows and only if economic agents find incentives and opportunities to save and to deposit. To be able to attract the depositor is thus indispensable for the transfer of purchasing power from surplus to deficit units. This poses a potential conflict, to the extent to which interest rates attractive for the depositors may increase the cost of funds for the borrowers.

Inflation erodes the purchasing power of deposits and the purchasing power of loan portfolios. To avoid this erosion, depositors transfer their purchasing power to other assets that are better forms of holding wealth in an inflationary economy, because they conserve value: real estate, inventories, precious metals. Similarly, to avoid the threat to their purchasing power from devaluation, depositors transfer it abroad; they buy foreign currencies (dollars) or open bank accounts in Miami. The consequence is a reduction of the real value of the deposits held in the domestic financial system.

The main responsibility of a financial intermediary is, in turn, to keep the integrity of its loanable funds. The intermediary keeps those funds in custody, in the name of depositors (or international agencies) that entrusted those funds, so they could, in turn, facilitate the borrowers' productive activities. If the intermediary does not protect those funds, it breaks its agreement with the depositors, who expect to recuperate the wealth they have made available to others. If this purchasing power is not protected, the intermediary will find it impossible to offer loan services to its borrowers, when these need its support.

To keep the integrity of its loanable funds, the intermediary must avoid their erosion by inflation. This will only be possible if the rates of interest charged are positive in real terms; that is, if they are higher than the inflation rate. Since depositors look for protection from inflation, as well, the intermediary must pay a positive real rate of interest for the savings mobilized. The institution's interest rate policies must respond, therefore, to expected inflation rates.

An intermediary that charges only 50 percent of nominal interest on its loans, with an inflation rate of 100 percent per year will experience, on this account only, a reduction of the purchasing power of its portfolio to two-fifths in only three years. Thus, it will be in a position to offer the same credit service to only 40 percent of its original clientele. If it tried to service all of these clients, it could offer no more than 40 percent of the purchasing power originally transferred. One way or another, the quality of the service would have deteriorated and the institution would lose the support of both its depositors and borrowers.

Inflation forces the financial institution to revise its procedures. Accounting practices must be modified, in order to reflect the real value of assets and liabilities and to avoid decapitalization. The greater variability of prices that usually accompanies an inflationary process, frequently coupled with selective price controls, makes the evaluation of lending risks even more difficult. Portfolio management practices have to be revised.

In order to keep the integrity of its loanable funds, the institution must also collect its loans. An intermediary that each year loses 20 percent of its portfolio because of default will be decapitalized the same as with an equivalent rate of inflation. Moreover, delinquency generates a negative demonstration effect. If others do not pay, and get away with it, why should I pay?

In order to keep the integrity of its loanable funds, an institution must avoid operational losses as well. This implies both a reduction of operation costs, avoiding waste and inefficiency, as well as sufficient revenues. Effectively earned interest is the main source of revenues for a financial intermediary. The rate of interest charged on the loans must cover expected inflation and the institution's operating costs, at the same time that it makes it possible to build sufficient reserves against default losses and it offers an attractive remuneration to the depositors. To achieve this balance is not an easy task.

Third, an agricultural development bank will be viable to the extent to which it offers high-quality financial services. A farmer is interested not only in sufficient purchasing power from the loan; he also wants the funds to be timely disbursed, the loan procedure to be easy and flexible, the amortization schedule to adequately correspond to his cash flow, and the loan term to be sufficiently long. All of these features determine the quality of service. The farmer wants, in particular, access to a financial institution that offers timely, reliable, encompassing, and permanent services.

It is not always easy to establish creditworthiness. For this purpose what is most important is for the lender to acquire enough information about the borrower, in order to be able to estimate the probability of lack of repayment. This information is accumulated through experience and a continued relationship with a particular client. Once his reputation as a good borrower has been established, the client protects it, since it is a valuable intangible asset. This asset is more valuable if the credit program is permanent rather than transitory.

The borrower also expects the program to be reliable; the expected losses from lack of access to credit when this is needed, such as during an emergency, can be high. Untimely service may also cause additional costs for the producer. The more complete the service, such as in a "financial supermarket," the greater the convenience and the less the cost for the client. There are many advantages for the client from both holding his deposits and conducting his credit transactions at the same institution.

The public agricultural development banks have not offered high quality services. Because of targeting and loan supervision, their credit services have been narrow and many financial needs have been left unmet. Frequently, these banks have not offered depositing facilities. Given their dependency on outside funds, their credit programs have not been permanent and reliable. Rather, their funds have expanded and contracted with the ebb of flows of foreign assistance. Given the excess demand for credit that results from subsidized loans, long delays in disbursement and less than sufficient loan amounts have become frequent rationing devices. Many of their clients have been forced to search for complementary services elsewhere, further increasing their costs.

The client's first interest, therefore, is a solid and viable institution with which to develop a long-term financial relationship. This is, indeed, the nature of his implicit contract with the informal moneylender. The farmer is not interested, for these reasons, in policies that reduce the quality of the services offered. Of course, if money is being given away, he will not refuse it, but most likely he will value the institution less. A bank that is not valued by its customers is not viable.

Fourth, the viability of an agricultural development bank is strengthened if it offers low-cost services. This does not mean that interest rates must be kept at artificially low levels. What is the value of too low an interest rate, if the loans are disbursed several months later, when they are not needed any longer, or if the bank does not authorize the expenditures that the farmer wants? What is the value of an artificially low interest rate, if it decapitalizes the bank to the point that it has to drastically reduce the amounts that it can lend? What is the value of subsidized credit, if the farmer can get it this year but not the next?

It becomes necessary to recognize that, in order to be able to offer high quality services, development banks need adequate operation margins. It is necessary to recognize, as well, that poor quality services impose additional costs on the farmer, that make credit even more expensive. Delayed loans reduce the profitability of his productive activities. Cumbersome procedures waste his time and effort. Bankers who do not know the activities being financed cannot be useful to their clientele. What seems cheap turns out to be expensive.

Financial services are not cheap. The operation of the financial system is costly both for the intermediaries and their clientele. What matters, for production and investment decisions, is the total cost of the funds for the borrowers. Interest payments are only a portion of these costs, frequently not the most important. There are other implicit costs, such as the opportunity cost of the time spent in the transaction or the losses due to delays in the disbursement of the funds. There are legal expenses, commissions, accounting statements, feasibility studies, taxes, travel costs, and bribes. There are risks of law suits and losses of collateral, if things do not go well. When these other costs are high, loans are expensive. These costs beyond interest payments tend to be particularly high in the case of small transactions.

What matters for the behavior of savers is the net return on deposits, once taxes, travel expenses, and the cost of standing in line at a bank branch are subtracted from interest earned. A small depositor from a distant place, who earns 6 pesos a year on his passbook account's balance of 100 pesos, cannot even pay for the bus fares for the trip to withdraw his interest earnings. He will be forced, in this case, to accumulate wealth in other forms, perhaps domestic animals.

What matters for the intermediary is a financial margin that covers the costs of funds mobilization and the costs and risks of lending and that leaves a profit that allows growth. A public or private financial intermediary that is not profitable, stagnates, and if it makes losses, it shrinks and it disappears. This can happen to any institution that is not worried about its profitability. It has been the case of numerous public development banks.

The main indicator of financial progress is a reduction in the transaction costs incurred by all, actual and potential, market participants. A reduction in these costs that, among other things, allows a shrinking of financial margins, is the most effective way to simultaneously favor both borrowers and depositors. If the intermediary operates with smaller margins, it will be in a position to offer a more attractive rate of interest to depositors, while at the same time it charges less to its borrowers. The ultimate challenge is this greater efficiency, that reduces the potential conflict between borrowers and depositors.

Intermediation margins are too wide when there is not a vigorous loan collection efforts, since this forces the financial institution to accumulate reserves in order to avoid decapitalization. In addition to a greater operational efficiency, in order to reduce the cost of credit and reward depositors better, a reduction of delinquency is also necessary.

The lower are interest rates artificially set, on the other hand, the lesser the degree of access and the greater the number of farmers excluded from formal credit portfolios. The choice is inevitable: either cheaper credit but for less, or non-subsidized credit for a larger number and in greater amounts for each one. It is not possible to have more, without paying more.

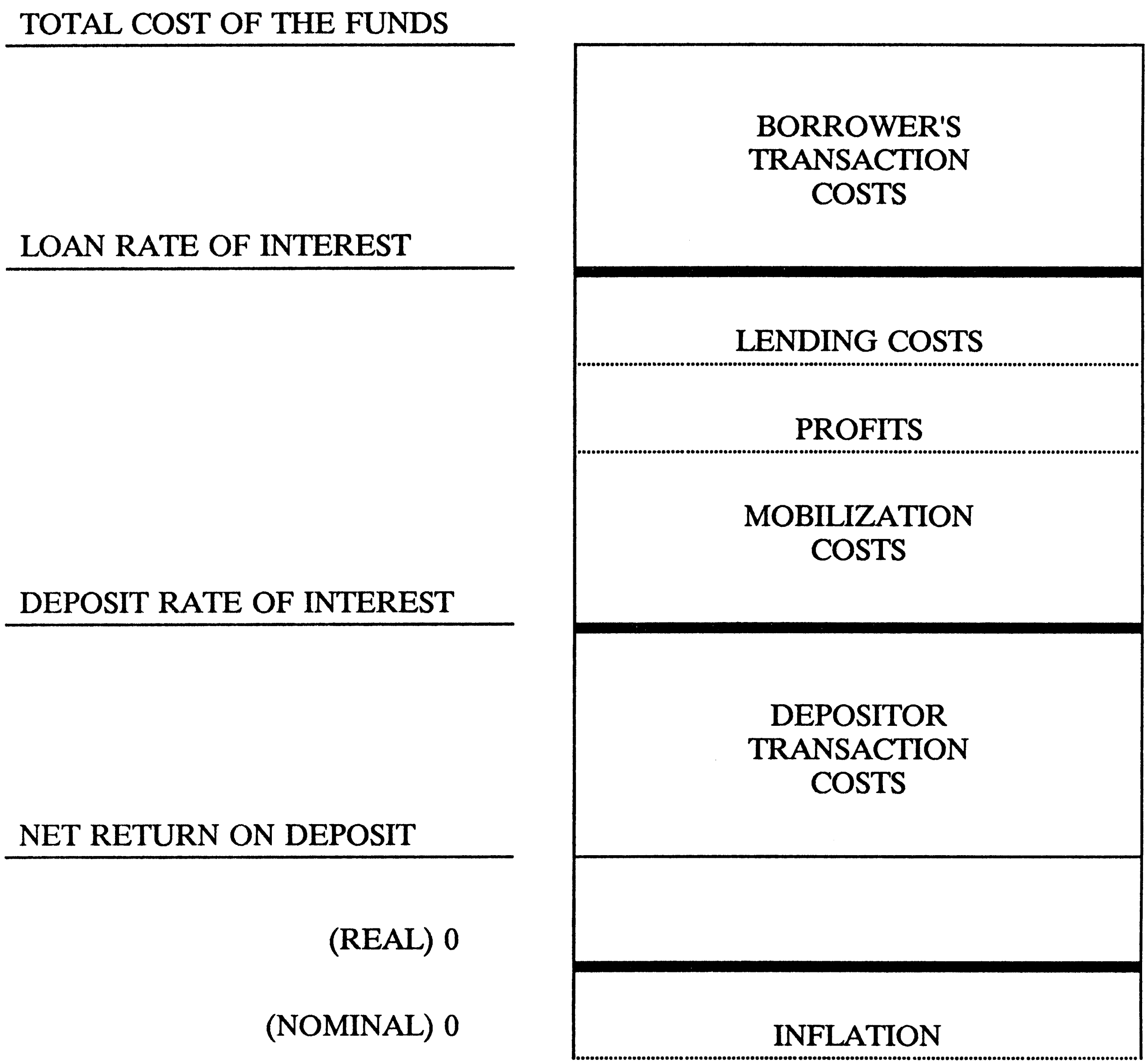
Similarly, the lower are interest rates artificially set, the poorer the quality of services provided. Quality has a cost. Finally, the lower are interest rates artificially set, the higher the transaction costs incurred both by the client and the intermediary. Under-equilibrium interest rates generate an excess demand for credit that requires non-price rationing to clear the market. This rationing increases transaction costs for all market participants. These costs are more burdensome and less equitable than interest rates closer to equilibrium levels. Cheap credit, in the end, is expensive.

In summary, the financial system contributes to economic development if, once all uses of real resources are taken into account, its operations imply low costs, for its clientele and for society as a whole. The operation of the financial system at too high costs implies a waste of resources. These resources could be more profitably employed in other activities: the farmer cultivating his farm, instead of traveling to the bank in order to find out what ever happened to his loan application; the depositor looking after his business, instead of waiting in line for hours at a bank branch; the redundant employee of a financial institution contributing with his efforts to another productive activity. Simply setting ceilings on interest rates cannot eliminate these excessive social costs.

VI. Towards Viable Agricultural Development Banks

The task of the agricultural development banks is costly and difficult, but they can still play a key role in promoting welfare in the rural areas of the developing countries. The special nature of the rural economy explains some of the problems. Potential depositors and borrowers are heterogeneous and geographically dispersed, their transactions are small, and risks are high. Their activity is highly dependent on exogenous forces. The consequences are high transaction costs and high risks, that reduce both the demand and the supply for rural financial services. In these circumstances, to become a viable financial intermediary is a difficult task.

TRANSACTION COSTS



Potential depositors find that the net return on their deposits is too low and save in other forms. Potential borrowers find that the total cost of formal loans is too high and seek the informal sources of credit. Development banks discover that the costs of administering a multitude of small savings accounts are too high. Development banks also discover that the costs and risks of evaluating and administering a multitude of small loans are too high. In order to overcome these obstacles, major efforts are required.

Viable agricultural development banks would require:

(a) changes in the environment in which they operate,

(b) changes in the financial policies that regulate their operation,

(c) changes in their institutional design, and

(d) improvements in their financial technologies.

Elements of the environment determine the profitability and risks of agricultural activities and, as a result, the profitability and risks of loans to farmers. Modification of the environment is important, because the growth potential of a financial intermediary, such as an agricultural development bank, depends to a good extent upon the solvency and dynamism of its clientele. Farmers with low and unstable returns cannot become good bank clients. Low incomes limit their savings capacity and their ability to transform some of their assets into financial deposits. Low incomes reduce their desire to borrow, limit their opportunities to profitably use loan funds, and diminish their ability and willingness to repay those loans. Agricultural development banks will be more viable and successful when farmer returns are high, rural incomes grow, and economic policies do not discriminate against farming. It is important to recognize, nevertheless, that credit, by itself, cannot increase the profitability of agriculture. Credit is not a panacea. The solution is elsewhere.

The development of the country's infrastructure, greater security in land tenure arrangements, and a legal framework that protects property rights and the enforcement of contracts increase resource productivity and reduce transaction costs and, in this way, promote rural financial markets and the viability of agricultural development banks.

Economic policies that repress rural incomes and increase their variability constrain deposit and loan demand and reduce creditworthiness. In addition to the price policies, taxes and subsidies that critically influence farmers' incomes, appropriate macroeconomic management and financial policies are crucial for the promotion of rural financial markets. Cautious macroeconomic management promotes stability and protects financial transactions from inflation. Prudential supervision of financial intermediaries promotes, on the other hand, their solvency and, thereby, the public's confidence. This trust is indispensable for firms and households to channel their savings through the domestic financial system.

Rigid and inappropriate financial policies have repressed financial market growth and reduced the viability of agricultural development banks in many developing countries. Combined with inflation and devaluation, interest-rate restrictions have resulted in negative net returns for depositors, in real terms, and have promoted dollarization and the contraction of the regulated financial system. The expansion of the non-regulated system has produced, in turn, a greater degree of market fragmentation. Excessively high reserve requirements have had the same effect. Interest-rate restrictions have forced intermediaries to adopt non-price rationing criteria that have penalized "difficult" clientele, including many farmers. Restrictions of competition in financial markets have reduced the system's efficiency.

In addition to non-repressive policies and a more adequate regulatory environment, promotion of rural financial markets requires viable, independent, permanent, and efficient institutions. Inconsistent objectives have reduced the viability of agricultural development banks. Excessive specialization has increased their portfolio risks. Lack of deposit mobilization has made them weaker institutions. A revision of their objectives is indispensable, in order to emphasize their mission as financial intermediaries for the rural areas. For this purpose, the agricultural development banks possess a comparative advantage based on their widespread network of rural branches, their knowledge of the rural areas and of their clientele, and the motivation of their staff. Acquisition of these assets requires fixed investments that represent formidable barriers to entry for other formal intermediaries. Even in the case of the agricultural development banks, there is substantial unutilized excess capacity in their network of branches. Given the high costs for other intermediaries of supplying these services, agricultural development banks may still play an important role.

Institutional performance is critically determined by the behavior of managers, employees, and customers of the agricultural development bank. The incentives that guide the actions of these agents are crucial and should be the focus of any efforts of institutional strengthening. A structure of incentives that rewards good decisions and defines accountability and penalties for bad decisions is required. Furthermore, the intermediary must have enough authority to evaluate loan applications with independence and collect loans with energy. Political intrusion must be eliminated. Given the importance of information and of a detailed knowledge of the customer's activities in decisions about creditworthiness, the decentralization of decision-making is critical, as well. For decentralization to work, however, communication channels must be improved.

Similarly, new financial technologies (tools and procedures) are needed, in order to increase access to services, improve the quality of these services, and reduce transaction costs. New instruments are indispensable to more efficiently collect, process, and take advantage of information for decision-making and to improve risk management. Unless transaction costs are significantly reduced for all market participants, it will continue to be impossible to provide financial services to a wide rural clientele. Unless new financial technologies substantially reduce these costs, it may be impossible to improve the viability of the agricultural development banks.